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ALLEGATIONS CONCERNING DEFENSE REUTILIZATION
AND MARKETING SERVICE BUSINESS PRACTICES

Report No. D-2002-025

December 17, 2001

Office of the Inspector General
Department of Defense

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Acronyms

CONUS	Continental United States
DLA	Defense Logistics Agency
DRMO	Defense Reutilization and Marketing Office
DRMS	Defense Reutilization and Marketing Service
FSC	Federal Supply Class
GAO	General Accounting Office
NPR	National Performance Review
SBA	Small Business Administration



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

December 17, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Allegations Concerning Defense Reutilization and Marketing Service Business Practices (Report No. D-2002-025)

We are providing this report for information and use. This audit was performed in response to a congressional request from Senator John Warner that was based on allegations his office received.

No written response to this report was required, and none was received. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Tilghman Schraden at (703) 604-9186 (DSN 664-9186) (tschraden@dodig.osd.mil) or Mr. Alexander McKay at (215) 737-5421, ext. 232 (DSN 444-5421, ext. 232) (amckay@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma
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Acting Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2002-025

(Project No. D2001LD-0092.001)

December 17, 2001

Allegations Concerning Defense Reutilization and Marketing Service Business Practices

Executive Summary

Introduction. We performed this audit in response to a request from Senator John Warner. The request was based on several allegations the senator's office received concerning the operations of the Defense Reutilization and Marketing Service (DRMS) in regard to the disposal of excess material. As of September 2001, DRMS had 69 offices that disposed of excess material with annual operating costs of \$299.4 million. Of the 69 offices, 4 were regional centers with the authority and capability to demilitarize weapon systems and related items in the interest of national security and public safety. In FY 2001, DRMS total sales were about \$54 million.

Objectives. The overall audit objective was to review the allegations, which addressed DRMS costs to transport items to regional centers for demilitarization and the impact on small businesses of changes in DRMS operations for selling excess property and scrap.

Results. The allegations were not substantiated. DRMS made a decision to centralize demilitarization operations to add necessary controls for national security purposes and public safety over the sale of items that require demilitarization. Additional transportation costs were incurred, but the changes in the demilitarization process did provide some economies in the overall operations. DRMS changed the manner in which it sells excess material as part of an implementation plan to improve business practices that did not adversely impact small business opportunities. The sale of wall lockers as scrap material by DRMS was appropriate because the sale of the lockers as usable surplus material would have resulted in costs that exceeded anticipated proceeds. The contractual requirement for the contractor to provide containers for the removal of scrap material and the DRMS decision to sell an entire batch of scrap material to a single contractor instead of breaking it up into parcels were not barriers to small business participation and a small business was awarded the contracts. See the Results section of the report for the specific allegations and details of our review.

Management Comments. We provided a draft of this report on October 29, 2001. No written response was required, and none was received. Therefore, we are publishing this report in final form.

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Background

We performed this audit in response to a congressional request. Senator John Warner requested that a cost comparison be conducted of the new transportation cost to ship scrap materials from military bases to Defense Reutilization and Marketing Service (DRMS) regional locations for demilitarization and the revenue that DRMS would have received if the scrap material had been sold by local Defense Reutilization and Marketing Offices (DRMOs). Senator Warner also requested that we determine whether DRMS had made an assessment of the impact on small businesses from the consolidation of its scrap and surplus material operations and the bundling of associated contracts. In a meeting with the staff of the Senate Armed Services Committee, the staff clarified that Senator Warner's request was on behalf of a constituent of Senator Jesse Helms. The staff requested that we contact the constituent and evaluate his concerns. Upon meeting with the constituent, we received several specific allegations concerning the operations of DRMS. The allegations addressed costs to transport items to regional centers for demilitarization and the impact on small businesses of changes in DRMS operations for selling excess material. Specifically, the complainant made the following allegations.

- DRMS incurred unnecessary transportation costs by moving items that required demilitarization.
- DRMS has been changing the manner in which it sells material, which placed a barrier to small business participation.
- The DRMO at Camp Lejeune, Jacksonville, North Carolina, inappropriately sold wall lockers as scrap material instead of selling them as usable surplus material.
- The DRMO at Camp Lejeune required that a contractor provide five containers for the removal of scrap material as a condition of the contract. That requirement was a barrier to small business participation.
- The DRMO at Camp Lejeune sold a batch of scrap material to a single contractor rather than break it up into smaller units. That method of sale was a barrier to small business participation.

DRMS Organization and Mission. DRMS is an organization within the Defense Logistics Agency (DLA) that is responsible for the reutilization, transfer, donation, sale, and disposal of inventory items that become excess to DoD requirements. DoD organizations turn in excess material to DRMS for disposition. DRMS uses a priority system to dispose of excess material. The first priority is redistribution of excess material to another DoD user that has a requirement for the item. The next priority is donation to qualified nonprofit organizations. The final disposition priority is sale of the item to the general public. DRMS may sell material to the general public as usable surplus material or as scrap material. In FY 2001, DRMS total sales were about \$54 million.

Demilitarization. In selling items to the public that were used for a military purpose, DRMS has the responsibility to ensure that the items are disposed of in a way that does not pose a threat to national security or public safety. The process that DRMS uses at selected DRMOs to render military equipment ineffective is called demilitarization. Demilitarization can be accomplished by mutilating, cutting, crushing, scrapping, melting, burning, or altering the equipment and material to prevent its further use for its originally intended military or lethal purpose. As of September 2001, DRMS had 69 U.S. offices that disposed of excess material with annual operating costs of \$299.4 million. Four of those 69 offices had the authority and capability to demilitarize weapon systems and related items in the interest of national security and public safety.

DRMS Operations. The end of the Cold War triggered a sequence of events to improve Government operations by implementing management initiatives throughout the Government, such as reengineering processes, downsizing organizations, privatizing functions, and instituting better business practices. The new Government initiatives affected DRMS operations and caused major changes in how DRMS conducted its business. Consistent with the new initiatives, in 1992, DLA directed DRMS to become self-sufficient by balancing sales revenue and its overall operating costs. In response to the DLA direction, DRMS began actively examining alternative business practices.

During that period, the National Performance Review (NPR), subsequently called the National Partnership for Reinventing Government, was established to oversee and ensure improved Government operations. The need to reduce the number of Government personnel and to reduce the cost of all Government activities, particularly in DoD organizations, had an immediate impact on DRMS in its exploration of new business practices. The Deputy Secretary of Defense also designated DRMS as a Reinvention Laboratory, specifically to assist in the study of alternative privatization methods.

In February 1996, the Deputy Secretary of Defense approved the DRMS Enterprise Management business philosophy, allowing DRMS the ability to selectively privatize its operations and to work with industry to incorporate private sector management approaches. Then, in June 1996, an NPR Committee determined that DRMS should explore using the private sector to sell excess DoD material.

By pursuing various management initiatives, DRMS became a smaller organization. DRMS consolidated DRMOs, reducing operating costs, requiring less equipment, and reducing the number of locations and personnel. DRMS reduced its operating budget from \$380 million in FY 1996 to \$299.4 million in FY 2001. DRMS anticipates future initiatives to further reduce its operating budget to \$286.6 million by FY 2005 (see Appendix B). DRMS is continuing to develop integrated business strategies, including the Scrap Venture Program, to further reduce operating costs.

Scrap Venture Program. For the Scrap Venture Program, DRMS decided to award three sales contracts to sell scrap material on a regional basis. DRMS would receive a share of the net proceeds of sales. All DRMOs in the continental United States (CONUS), with the exception of North Carolina, South Carolina, and Tennessee, were planned to participate in the Scrap Venture Program. DRMS will receive about 80 percent of the net revenue from sales under the program.

Small Business. The Small Business Administration (SBA) establishes the requirements for Federal organizations in their dealings with the small business community. The Government property sales assistance program within SBA ensures that small businesses obtain their fair share of all Federal personal property qualifying for sale or other disposal action. The Code of Federal Regulations, Title 13, defines a small business for recyclable material wholesalers, or the scrap industry, as one with 100 or fewer employees.

Objectives

The overall audit objective was to review the allegations, which addressed DRMS costs to transport items to regional centers for demilitarization and the impact on small businesses of changes in DRMS operations for selling excess property and scrap. See Appendix A for details on the audit scope and methodology and for prior coverage.

DRMS Business Operations

The allegations concerning transportation costs for items requiring demilitarization and barriers to small business opportunities were not substantiated. DRMS made a decision to centralize demilitarization operations to add necessary controls for national security purposes and public safety over the sale of items that require demilitarization.

Additional transportation costs were incurred, but the changes in the demilitarization process did provide some economies in the overall operations. DRMS changed the manner in which it sells excess material as part of an implementation plan to improve business practices that did not adversely impact small business opportunities. The DRMS sale of wall lockers as scrap material was appropriate because the sale of the lockers as usable surplus material would have resulted in costs that exceeded anticipated proceeds. The contractual requirement for the contractor to provide containers for the removal of scrap material and the DRMS decision to sell an entire batch of scrap material to a single contractor instead of breaking it up into parcels were not barriers to small business participation and a small business was awarded the contracts.

Transportation of Items Requiring Demilitarization

Allegation. DRMS incurred unnecessary transportation costs by moving items that required demilitarization.

Audit Results. The allegation was not substantiated. The decentralized process for demilitarization of excess material within DRMS was ineffective and inefficient. Because of inadequate controls at local DRMOs, material had been released to the public and foreign nationals that resulted in international and national incidents. Additionally, local DRMOs were unnecessarily expending resources to demilitarize commercially available items, such as lighting fixtures, tools, and cotter pins, and significantly reducing the value of the items before selling the material. The DRMS decision to centralize demilitarization operations was appropriate because it added necessary controls over the sale of items that required demilitarization and provided a more cost-effective means of accomplishing the DRMS demilitarization mission.

During the 1990s, the DRMS demilitarization process was under criticism from the news media, Congress, the General Accounting Office (GAO), and the Inspector General, DoD, because surplus military material, including parts for aircraft, missiles, tanks, and rifles, was getting into the hands of foreign nationals or private citizens and was causing international and national incidents. For example, a December 9, 1996, *U.S. News & World Report* article reported that foreign buyers, such as Iran, Iraq, and China, were purchasing high-tech surplus military items, including encryption devices, submarine propulsion parts, radar systems, electron tubes for guided missile systems, and parts for stealth fighter aircraft.

When DRMS began its management initiatives to downsize and restructure functions in 1996, there were 152 DRMOs throughout the United States and the demilitarization process was dispersed unevenly among those offices. The organization and nonstandard procedures for demilitarization contributed to control weaknesses over access to military items by the general public and foreign nationals. To improve the controls, DRMS initiated actions to centralize the demilitarization process in March of 1998. DRMS centralized demilitarization to nine sites in March 1999. The nine sites were Anniston, Alabama; Crane, Indiana; Fort Lewis, Washington; Fort McClellan, California; Letterkenny, Pennsylvania; St. Juliens Creek, Virginia; Texarkana, Texas; Tucson, Arizona; and Warner Robins, Georgia. Based on the results of a November 1999 study by Analysis Group, Inc., DRMS consolidated the demilitarization operations from nine to four sites. The four sites, in Anniston, Crane, Texarkana, and Tucson, provide demilitarization support to 69 DRMOs in CONUS. Generally, items sold by DRMS that require demilitarization pass to the general public as scrap through one of those four centralized demilitarization sites. However, on an approved exception basis, material can be demilitarized at another site.

At a centralized demilitarization site, specialized personnel perform the demilitarization tasks. All of the specialists undergo a series of training programs that make them proficient in numerous demilitarization techniques. At the four sites, DRMS is able to concentrate its investment in the specialized equipment required to perform demilitarization. That is in contrast to the previous decentralized system in which the responsibility for the performance of demilitarization was one of many functions assigned to all of the DRMOs. A small percentage of material requiring demilitarization is sold at either a DRMO or at the organization that has the excess material, with demilitarization performed by the sales contractor. That process is used when an item is too large to easily or economically transport to one of the centralized demilitarization sites. DRMS controls the process by requiring approved surveillance plans and Government oversight of the contractor's performance of demilitarization.

Although the change in DRMS operations to centralized demilitarization was driven primarily by the need for added control over material requiring demilitarization, DRMS did consider the cost impact of the change. DRMS determined that centralized demilitarization yielded economies in the areas of personnel and equipment. An independent contractor, Analysis Group, Inc., completed a study for DRMS in November 1999 to evaluate the financial impact of the centralized demilitarization concept for the nine operating demilitarization sites. The study estimated an annual cost benefit of about \$682,000 by centralizing and reducing demilitarization operations to four sites. The study used a trade-off analysis considering transportation costs, processing efficiencies, and labor costs to determine the optimal set of sites for demilitarization.

Changes in DRMS Sales Practices for Scrap Material

Allegation. DRMS has been changing the manner in which it sells scrap material. The changes required a greater level of commitment on the part of the contractor that acquires the material. Those changes were a barrier to small business participation.

Audit Results. The allegation was not substantiated. Changes affecting the sale of scrap were part of larger business strategies directed by DLA authorities to improve the overall efficiency of DRMS operations. Although the changes may have affected commitments by individual contractors, the changes were not a barrier to small business participation.

DLA directed DRMS to reduce the number of its personnel, to privatize its functions, and to implement best business practices that would produce more efficient operations. Significant personnel reductions have already been achieved and more are planned (see Appendix B). In order to achieve those reductions, DRMS implemented numerous changes affecting its business practices. All of those changes formed an integrated plan that allowed DRMS to perform its mission while downsizing and privatizing.

The condition and type of material determines whether DRMS sells the material as usable surplus material or as scrap material. For both types of material, DRMS is moving toward partnering arrangements with contractors to perform the sales functions. Those arrangements have contributed to the ability of DRMS to downsize and still accomplish its mission because contractor personnel perform functions that were previously performed by DRMS personnel. The arrangements require contractors to be responsible for the sale and removal of material for a stated period of time. One of the arrangements is the Scrap Venture Program. In establishing the terms of the Scrap Venture Program contracts, DRMS was making a concerted effort to provide opportunities for small businesses to participate.

Prior to the development of the Scrap Venture Program, small businesses were actively participating in the sale of scrap material. In FY 2000, DRMS sold about \$31.9 million worth of scrap material in CONUS, and more than 92 percent of the scrap material was sold to small businesses. In FY 2000, 351 businesses purchased scrap material and 323 of them were small businesses.

In June 2000, DRMS began partnering for the sale of scrap material on a limited regional basis. The program, titled Scrap Pilot, is the forerunner to a planned scrap removal program titled Scrap Venture. Scrap Venture contracts will be awarded on a geographic basis and will include 45 CONUS states. The excluded states are North Carolina, South Carolina, and Tennessee. DRMS personnel estimated that those contracts will be awarded in April 2002. In preparation for the beginning of the Scrap Venture arrangement, DRMS management was conducting discussions with the small business community to incorporate small business concerns into the terms and conditions of the contracts.

To address the concerns of the small business community, DRMS was making the following specific provisions for the Scrap Venture:

- establishing a control area of the country that will not be covered by the Scrap Venture contracts in order to provide a basis for comparison of the impact of Scrap Venture on the small business community;
- including a small business resale provision in the terms and conditions of the Scrap Venture contracts that will provide incentives to the Scrap Venture contractor to involve the small business community in the resale of material;
- providing a point of contact within DRMS to respond to the continuing needs of the small business community;
- sending DRMS representatives to small business conferences to enable DRMS to be aware of the concerns of the small business community; and
- agreeing to report an analysis of the Scrap Venture impact on small businesses to Senator Jesse Helms' office.

Sale of Wall Lockers at Camp Lejeune

Allegation. The DRMO at Camp Lejeune, Jacksonville, North Carolina, inappropriately sold wall lockers as scrap material instead of selling them as usable surplus material.

Audit Results. The allegation was not substantiated. The sale of the wall lockers as scrap material was appropriate. DRMOs have the authority to decide on the sale method for items based on what is most advantageous to the Government. The DRMO at Camp Lejeune determined that selling the lockers as usable surplus material would have resulted in anticipated costs exceeding anticipated revenues. The generating organization, Marine Corps Base Camp Lejeune, turned in 1,378 wall lockers between January 2000 and May 2001. DRMO management decided to sell the lockers as scrap material instead of selling them as usable surplus material. That decision was made after considering several factors, including:

- the availability and cost of personnel to process the lockers for sale (personnel costs to process a sale of usable material include the costs to move, record, and sell the items),
- past sales offers,
- available storage space, and
- the condition of the lockers (the lockers were in poor to fair condition when DRMO, Camp Lejeune, received them).

Contractual Requirement for Containers for the Removal of Scrap Material at Camp Lejeune

Allegation. The DRMO at Camp Lejeune required that a contractor provide five containers on site for the removal of scrap material as a condition of the contract. That requirement was unreasonable and was a barrier to small business participation.

Audit Results. The allegation was not substantiated. The requirement to provide containers for the removal of scrap material was not a barrier to small business participation. The inclusion of the contract clause was consistent with other DRMS strategies to reduce personnel requirements and improve business processes, and it was clearly in the best interest of the Government. The practice enabled generating organizations to place discarded scrap material directly into containers that could then be picked up by the contractor. The practice streamlined the process by eliminating the need for DRMO personnel to handle the material. The containers also provided an environmental benefit by reducing the potential for ground contamination.

On September 8, 2000, the DRMO awarded contract number 31-0643-0004 for the removal of scrap material at Marine Corps Base, Camp Lejeune. The contract had a requirement for five containers that could each handle 65 cubic yards of scrap material. The specifications were based on the volume of scrap material generated by the serviced organizations. Southern Metals Recycling, a small business with about 25 employees, was able to comply with the specified requirements, was awarded the contract, and was successfully performing under the contract.

Bulk Sale of Scrap Material at Camp Lejeune

Allegation. The DRMO at Camp Lejeune sold a batch of scrap material to a single contractor rather than break it up into smaller units. That method of sale was a barrier to small business participation.

Audit Results. The allegation was not substantiated. In April 2000, Marine Corps Base, Camp Lejeune, notified its DRMO that the DRMO would no longer be permitted to conduct business at the outside storage location at Camp Geiger because of surface contamination. Camp Geiger is a satellite location of Camp Lejeune. The DRMO at Camp Lejeune was required to remove all gear, equipment, material, and personnel from that location by May 5, 2000, in order to allow for the environmental cleanup. Initially, the environmental cleanup prevented any access to the site and delayed the sale and removal of the scrap material. The DRMO decision to require the contractor to provide for the removal of all the material was necessary because the DRMO had neither the personnel nor the equipment at Camp Geiger to accomplish the task. The contractor accomplished the timely removal of the scrap material.

The DRMO at Camp Lejeune had a total of 874,112 pounds of scrap material to be sold. The material was sold through two contracts, one advertised nationally and one negotiated locally. Southern Metals Recycling, a small business of about 25 employees, bought all of the material. Contract number 31-1606-0017 was awarded on December 27, 2000, from the national solicitation, and contract number 25-1016-0001, Item 1, was awarded on January 16, 2001, as a result of the locally negotiated sale. Southern Metals Recycling removed all of the material from the site by February 1, 2001.

Appendix A. Audit Process

Scope and Methodology

Work Performed. We contacted and discussed the allegations with the staff of the Senate Armed Services Committee and traveled to Jacksonville, North Carolina, to interview the complainant. We also interviewed officials at DLA, DRMS, and the DRMO at Camp Lejeune, North Carolina, to collect information concerning changes in the manner in which DRMS conducted business and how those changes impacted small business opportunities. We developed the history of the changes in the DRMS business practices affecting demilitarization from newspaper and magazine articles, command briefings, independent studies, the NPR, the Defense Performance Review, and prior audit reports. The documents we reviewed included the Code of Federal Regulations, DoD and DLA guidance on DRMS, contracts on the removal and sale of scrap material, cost studies on the consolidation of demilitarization, official correspondence, and summary disposal data related to scrap sales. The documents we reviewed were dated from January 1991 through November 2001.

Limitations to Scope. Because our objective was limited to evaluating allegations related to changes in DRMS business practices and their impact on small businesses, we did not review the management control program.

High-Risk Area. GAO has identified several high-risk areas in DoD. This report provides coverage of the Defense Infrastructure high-risk area.

Use of Computer-Processed Data. We used computer-processed data that came from the DRMS database for scrap sales. To the extent that we reviewed the computer-processed data, we concluded the data were sufficiently reliable to be used in meeting our objectives. We did not audit the system that produced the data.

Audit Type, Dates, and Standards. We performed this economy and efficiency audit from March through October 2001 in accordance with generally accepted government auditing standards.

Contacts During the Audit. We visited or contacted the complainant, individuals and organizations within DoD, and the staff of the Senate Armed Services Committee. Further details are available upon request.

Prior Coverage

GAO issued two reports and the Inspector General, DoD, issued three reports covering aspects of the disposal of items requiring demilitarization. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted Inspector General, DoD, reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

General Accounting Office

GAO Report No. NSIAD-98-182 (OSD Case No. 1632), "Defense Inventory: Action Needed to Avoid Inappropriate Sales of Surplus Parts," August 3, 1998

GAO Report No. NSIAD-91-10 (OSD Case No. 8462), "Property Disposal: Controls Needed to Preclude DoD Release of Unsafe Surplus M151 Jeeps," January 2, 1991

Inspector General, DoD

Inspector General, DoD, Report No. D-2000-170, "Disposal of Range Residue," August 4, 2000

Inspector General, DoD, Report No. D-2000-050, "Disposal of Munitions Items at Fort Irwin," December 8, 1999

Inspector General, DoD, Report No. 97-130, "Coding Munitions List Items," April 16, 1997

Appendix B. Reductions in DRMS

DRMS has had a significant reduction in its operations since FY 1996 as a result of several initiatives within the Executive Branch to downsize Government and institute best business practices. The need for personnel and equipment to perform demilitarization operations was effectively reduced as part of the overall downsizing and implementation of best business practices by DRMS. The following table illustrates the effect of the downsizing policies and presents actual data from FY 1996 through FY 2001 and DRMS projected estimates from FY 2002 through FY 2005 for DRMS operations.

**Actual and Projected Changes in DRMS Operations
From FY 1996 Through FY 2005**

	<u>Operating Costs (in millions)</u>	<u>Personnel Strength</u>	<u>DRMO Locations</u>
FY 1996	\$380.0	3,636	152
FY 1997	348.9	3,473	127
FY 1998	357.5	3,195	95
FY 1999	339.9	2,761	72
FY 2000	338.1	2,326	71
FY 2001	299.4	1,760	69
FY 2002	297.6	1,744	N/A*
FY 2003	292.5	1,586	N/A
FY 2004	286.1	1,477	N/A
FY 2005	286.6	1,410	10-20

*Not available.

Appendix C. Report Distribution

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House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Honorable Jesse Helms, U.S. Senate

Audit Team Members

The Readiness and Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

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